

## *PwC's Transfer Pricing Series*

### Master file, Local file; what you need to know

The lesson here is simple. In this new era, the best tax structures are those that will survive if all the information is made available to the tax authority. Anything short of this is akin to burying your head in the sand.

Effective July 2017, the OECD updated its transfer pricing (TP) guidelines for MNEs and tax administrations (“the Guidelines”) to align with the recommendations from the base erosion and profit shifting (BEPS) project.

Among other things, the 2017 edition of the Guidelines introduced a three-tiered approach to TP documentation for taxpayers with intercompany transactions. The approach includes the preparation of three documents, namely; a master file (MF), local file (LF) and country-by-country report (CbCR).

Prior to this revision, many jurisdictions, including Nigeria, only required taxpayers to prepare TP documentation that contained mostly information about the local company. Countries all over the world have started to adopt the three-tiered documentation approach and it is only a matter of time before Nigeria follows suit.

If you are familiar with the BEPS project, you are probably aware that transparency is a key objective of the project. With the new approach to TP documentation, taxpayers will be required to disclose a lot more information than they are used to disclosing to the tax authorities.

This article focusses on the objectives of the new approach and provides some insight on what taxpayers need to know about the master file and local file. We will also discuss the implications for Nigerian taxpayers.

#### **TP documentation prior to BEPS**

Prior to the introduction of the 2017 edition of the Guidelines, there was little specific guidance on the content of a TP documentation package. The old Guidelines emphasized the preparation of documentation which contained information which “reasonably” demonstrate the arm's length nature of related party transactions.

The Guidelines however, did not include a specific list of documents or information to be included in a TP documentation package; it had mainly broad guidelines on the type of information that could be included.

Since the reasonableness requirement was subjective, the direct consequence was that in order to meet compliance obligations, some taxpayers provided scant information and analysis which were not entirely useful to tax authorities. Insufficient information also meant that tax authorities were unable to conduct a transfer pricing risk assessment or quickly obtain information required for an audit enquiry.

### **TP documentation in the BEPS era**

The three-tiered approach introduced a standardized approach to transfer pricing documentation. The standardized approach is aimed at achieving three objectives.

The first is for taxpayers to self-assess their compliance with the arm's length principle. That is, TP documentation should clearly articulate taxpayers' transfer pricing policy and give the tax authority assurance the group has carefully considered its TP position. This means that from the onset, taxpayers would be able to determine their TP risk profile, by themselves, before the authorities query their arrangements.

The second and third objectives are closely related. While the second objective is to provide tax authorities with an effective tool for identifying targets for TP audits, the third objective states that the content of TP documentation is expected to provide tax authorities with the first level of information about the taxpayer, in the event of a TP audit.

Bearing in mind that TP audits are fact-intensive and can span a long period of time, the expectation is that the three-tiered approach to TP documentation will enable tax authorities conduct careful risk assessment; develop focused strategies; and effectively allocate resources to high risk cases rather than adopt a scattergun approach.

The benefit for taxpayers is that the likelihood of being selected for an audit reduces if they do not have risky arrangements and have prepared adequate documentation.

### **What is the master file?**

The master file (MF) is a document which contains high level information about the global business operations and TP policy of an MNE group. The MF will usually include standardized information about the group's organizational structure; significant

value drivers; main geographical locations; description of the business activities of members of the group (i.e. products, services, supply chain etc.); information about the group's intangibles; financing activities within the group (including external funding); and financial and tax positions of the MNE group.

The Guidelines provide that the master file should be made available to all relevant tax authorities in the jurisdictions where the members of the group are resident. Further, the MF may be prepared for the group as a whole or on a line of business basis, provided all centralized functions and transactions are described thoroughly in the MF.

### **What is a local file?**

The local file (LF) is similar to the TP documentation already prepared in the local jurisdictions of members of an MNE group. The LF provides more detailed information and analysis about the local entity's intercompany transactions and is expected to be filed with the tax authority in that jurisdiction.

The information provided in the LF would typically supplement the information in the MF and would include a detailed description of; the management structure of the local entity; related party transactions entered in the year; copies of related material intercompany agreements concluded by the local entity; application of TP methodology; and financial information of the local entity.

### **What does this mean for Nigerian taxpayers?**

If Nigeria puts in place regulations mandating the preparation of MF as part of the TP documentation package, Nigerian taxpayers (either as members of MNE groups with headquarters in Nigeria or as affiliates of offshore groups) will have the additional obligation to collate (or collect) and share a great deal of legal, economic and financial information about the group with the Federal Inland Revenue Service (FIRS).

This information will allow the FIRS assess the activities of foreign parties to the intercompany transaction and whether those activities support the transfer prices.

For taxpayers, this means they have to ensure that they can demonstrate the substance behind their existing structures and arrangements especially if those structures give them a tax advantage.

For instance, imagine there is a group with operating entities in Nigeria and other African countries. The group also has a financing entity situated in a low tax jurisdiction, say Mauritius, whose function is to lend money to fund the operations of the operating entities.

With the information contained in the MF, the FIRS will have a clearer picture of this arrangement and may start to question the rationale behind situating the financing entity in the low-tax jurisdiction, especially where all the activities of the financing entity are controlled by people located in Nigeria.

### Take away

In light of the recent wave of BEPS related conventions and initiatives Nigeria has entered into or introduced, one can conclude that it is only a matter of time before Nigeria introduces the new approach to TP documentation. Also, if the news (although premature) of the signing into law of the CbCR regulations (the third document in the three-tiered approach) is anything to go by, it suggests that the MF and LF requirements will soon follow.

In fact, some may argue that there is already an implied requirement for Nigerian taxpayers to have and be able to deliver a MF to the FIRS on request. This is because Regulation 11(b) of the Nigerian TP Regulations provides that the Regulations are to be applied in a manner consistent with the OECD TP Guidelines, as may be supplemented from time to time.

The lesson here is simple. In this new era, the best tax structures are those that will survive if all the information is made available to the tax authority. Anything short of this is akin to burying your head in the sand.



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